

changes are "beyond the carriers' control and not reflected in the general inflation and productivity growth adjustments"<sup>20</sup>, and therefore meet the Commission's standards for exogenous treatment.

Exogenous treatment of the administrative costs imposed by the new rules will be reflected as an increase in BellSouth's price cap index. If, as BellSouth suspects, the results of the estimated fair market value studies mandated by the proposed rules demonstrate that there is no significant difference between cost and fair market value, there will be little offsetting benefit to ratepayers. The increased costs to ratepayers imposed by the proposed regulations are certain and immediate; the offsetting benefits are remote and speculative.

C. There Is Unlikely To Be Any Substantial Benefit To Ratepayers If The Proposed Rules Are Adopted.

Ratepayers will receive a positive benefit from the proposed rule changes only if the application of the rules results in a net reduction in a carrier's regulated costs. BellSouth believes that such a result is highly unlikely. Carriers operating under incentive regulation for several years have had continuous incentives to identify and implement cost saving opportunities, both in their internal operations and in transactions with affiliates.

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<sup>20</sup> Id.

For example, BellSouth decided that it could improve efficiency by merging the two telephone companies, South Central Bell Telephone Company and Southern Bell Telephone and Telegraph Company, and their centralized staff organization, BellSouth Services, Inc., into a single organization, BellSouth Telecommunications, Inc. The merger not only increased efficiency, but it eliminated a significant source of affiliate transactions within BellSouth.

BellSouth has also reevaluated functions performed at the holding company level. Where a function performed at the holding company primarily benefited one subsidiary or group of subsidiaries, that function was transferred to those operating entities. This reorganization likewise resulted in reduced affiliate transactions.

BellSouth also adopted an internal policy to restrict affiliate transactions that did not meet the tariff rate or prevailing company price requirements of the existing rules. New affiliate transactions that would occur at fully distributed cost under the existing rules are authorized only after a stringent review to demonstrate both that the affiliate transaction is of strategic importance to BellSouth and that it is cost effective.

These actions, all of which were undertaken under the existing rules, demonstrate two points: 1) the existing price cap and affiliate transaction rules provide ample

incentive for carriers to operate efficiently; and 2) identifiable opportunities to improve efficiency have been or are being implemented, thereby reducing the likelihood that the onerous rules proposed in the Notice will produce additional consumer benefits.

D. The Proposed Rules Are Anticompetitive.

The proposed rules will require both the regulated carriers and their nonregulated affiliates to incur substantial administrative costs that are not incurred by their competitors. As such, the proposed rules would confer an unearned advantage to competitors of the carriers and their affiliates. In the absence of a clear public interest requirement for such rules, the Commission should not interfere with the operation of the competitive marketplace.

IV. The Specific Proposals Contained In The Notice Are Unnecessary And Unduly Burdensome

The Notice contains a series of specific proposals for revisions to the affiliate transaction rules. BellSouth generally opposes these proposals as unnecessary, unduly burdensome, or both. BellSouth discusses specific proposals below.

A. The Commission Should Not Restrict Or Eliminate The Use Of Prevailing Company Price As A Valuation Method.

The Commission's existing rules require that non-tariffed products or services be valued at the prevailing company price whenever the affiliate that provides the product or service also provides substantial

quantities of it to nonaffiliates.<sup>21</sup> The rationale behind this rule is that a third party's willingness to buy a product or service in substantial quantities at the offered price provides a reasonable assurance that the prevailing company price is reasonable.<sup>22</sup> Nothing in the Notice undermines this rationale.

The Notice cites reduced marketing costs, reduced transaction costs and reduced business risk as reasons for distinguishing affiliate transactions from nonaffiliate transactions, despite the existence of substantial third party transactions. It proposes to curtail prevailing company price as a valuation method because of these differences.<sup>23</sup> BellSouth disagrees with the assumption that these factors require abandoning prevailing company prices as a valuation method.

Nonaffiliated suppliers and customers frequently form close, long-term relationships that exhibit many of the same characteristics cited in the Notice. For example, automobile manufacturers frequently have nonaffiliated parts suppliers with long-term requirements contracts. Extraction industries such as oil and gas production and mining likewise develop close, long-term relationships between suppliers and customers that are not affiliated. Thus, the

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<sup>21</sup> Notice at ¶ 15.

<sup>22</sup> Notice at ¶ 16.

<sup>23</sup> Notice at ¶¶ 16-18.

mere existence of such relationships do not mean that prevailing company prices do not reflect market value.

Curtailling the use of prevailing company prices would put the LECs and their affiliates at a competitive disadvantage by forcing LEC affiliates to implement expensive accounting systems that their competitors are not required to utilize. These added costs could make a LEC affiliate, that would otherwise be the most efficient supplier, noncompetitive. Such distortions in the marketplace would harm the carriers and their customers.

The proposal in the Notice to draw a "bright line" between affiliates who provide most of their output to the carrier and other affiliates<sup>24</sup> is an unnecessary complication to an already burdensome set of rules. If an affiliate has substantial third-party transactions involving the product or service in question, that is sufficient assurance that the price charged reflects market value.<sup>25</sup>

BellSouth does not agree with the Commission that the "substantial third party transactions" standard requires clarification to avoid uncertainty as to when prevailing

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<sup>24</sup> Notice at ¶¶ 21-22.

<sup>25</sup> Proposed Section 64.903(a)(4) is unnecessary. Even if the Commission adopts its proposed "bright line" requirement, it is not necessary to have a special notation to that effect in the CAM. The use of the term "market rate" in Section V of the CAM will indicate that the "bright line" standard has been met.

company price is the appropriate valuation method.<sup>26</sup>

BellSouth believes that it is highly unlikely that an affiliate could successfully achieve substantial sales to nonaffiliates if its price exceeded market value.

Therefore, the existing standard is sufficient to protect ratepayers.

BellSouth objects to the vague and open ended nature of Sections 32.27(c)(2) and 32.27(d)(3) of the proposed rules. Rules of general applicability can only be adopted or changed in rulemaking proceedings. If the proposed wording of these rules is intended to incorporate requirements adopted in Commission orders other than general rulemaking proceedings, they would violate the Administrative Procedures Act.

B. The Commission Should Not Require Carriers To Estimate Fair Market Value For Either Asset Transfers Or Services.

The Notice proposes to retain the present asset transfer rules that require carriers to determine both the net book cost of an asset and its estimated fair market value.<sup>27</sup> The Notice also proposes to extend this requirement to the provision of services.<sup>28</sup> BellSouth opposes these proposals.

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<sup>26</sup> Notice at ¶ 89.

<sup>27</sup> Notice at ¶ 25.

<sup>28</sup> Notice at ¶ 32.

BellSouth has demonstrated in Sections II and III of these comments that onerous affiliate transaction rules are unnecessary and unduly burdensome. BellSouth recommended that the Commission eliminate the existing affiliate transaction rules for carriers subject to incentive regulation. If the Commission is unwilling to eliminate these rules in their entirety, the existing rules can be simplified to make them more consistent with incentive regulation.

BellSouth recommends that if asset transfer rules are retained for carriers subject to incentive regulation, they be reduced to a requirement that assets be transferred at net book cost. In times of increasing technological obsolescence, it is unlikely that depreciable assets of carriers would have a fair market value that is in excess of net book cost.<sup>29</sup> If the Commission believes that some limited class of assets may have a fair market value in excess of net book costs (such as land and buildings or artwork), it can make an exception for those classes of assets and require the application of the existing asymmetrical asset transfer rules to such transfers. Such an approach would simplify the valuation of asset transfers generally, while ensuring protection for ratepayers in those

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<sup>29</sup>See, e.g., AT&T Information Systems v. FCC, 854 F.2d 1442, 1446-47 (D.C. Cir. 1988); In the Matter of Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), 6 FCC Rcd 6066 (1991).

cases most likely to result in fair market value exceeding net book cost.

The Commission's proposal to require carriers to estimate fair market value for services is not only unduly burdensome, as shown in Section III of these comments, in many cases it is virtually impossible to estimate fair market value with any degree of precision. Take, for example, many of the services provided to BellSouth by Bellcore. Bellcore is responsible for providing a single point of contact with its owners for national security and emergency preparedness. How is the "fair market value" of such a service to be evaluated? Bellcore maintains a pool of trained scientists and engineers to respond to the needs of its owners. What is the fair market value of such a collection of unique talent?

The fact that Bellcore provides its owners with a full range of services for which each owner pays approximately one-seventh of the cost makes it virtually certain that the fair market value of the services received from Bellcore exceed the costs paid by each owner. It would be a pure waste of resources to require the carriers to estimate the fair market value of Bellcore's services.

BellSouth submits that it would be unreasonable to require carriers to estimate the fair market value of services received from their parent holding companies. Many of the functions performed at the holding company, such as



ensuring compliance with securities laws and filing consolidated tax returns can only be performed at the holding company level. Even if the carriers were divested and performed these functions for themselves, they would constitute a part of the cost of carrier operations. The fact that they are performed at the holding company level, with costs shared by all benefitting affiliates, virtually assures that ratepayers receive a savings compared with the cost of providing these services on an individual affiliate basis. Therefore, BellSouth opposes any Commission requirement that it estimate the fair market value of the services received from the holding company.

BellSouth also has substantial affiliated transactions with its subsidiary, BBS. BBS provides centralized marketing support for BellSouth's large business customers, many of whom operate nationwide. By providing products and services to these large customers through a separate subsidiary, BellSouth is able to avoid being subject to certain taxes in states outside the BellSouth region. In addition, BellSouth's structure facilitates a focused approach to these large customers that provide a disproportionate share of BellSouth's total revenue. BellSouth would not have created this organization if its management was not convinced that it facilitates increased revenue and reduced costs. This is precisely the incentive that the Commission intended when it adopted price cap

regulation. There is no justification for an overlay of additional costs that would arise if the Commission imposes a requirement that BellSouth estimate the fair market value of the services provided by this organization.

C. The Commission Should Rely On GAAP Accounting Whenever Possible.

The Notice recognizes that nonregulated affiliates keep their books in accordance with GAAP. The Notice proposes to continue to rely on GAAP accounting for nonregulated affiliates.<sup>30</sup> BellSouth agrees that the Commission should not attempt to impose accounting requirements inconsistent with GAAP on nonregulated affiliates of the carriers. Nor should the Commission require carriers to adjust amounts recorded in accordance with GAAP on the nonregulated affiliate's books when affiliate transactions are recorded on the carrier's books. Use of accounting data recorded in accordance with GAAP provides sufficient assurance of reliability that no additional measures are required to protect ratepayer interests.

D. The Commission Should Not Adopt Additional Cost Apportionment Requirements.

The existing rules require that costs incurred in the provision of both regulated and nonregulated services be apportioned in accordance with Section 64.901 of the Rules. If the Commission retains affiliate transaction rules for

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<sup>30</sup> Notice at ¶ 51.

carriers subject to incentive regulation, BellSouth recommends that the existing rule be retained as written.

The Notice at paragraphs 55 and 56 request comment on whether additional cost apportionments should be required in an effort to obtain more precision.<sup>31</sup> BellSouth opposes any such change in the rules. It would be inappropriate and unwarranted for the nonregulated affiliates to make Part 32 classification decisions for the LECs. Under the existing rules, costs incurred when the LEC purchases resources from a nonregulated affiliate are coded to the USOA account which properly reflects the LEC's use of those resources, not the origin of the cost by the nonregulated affiliate. For example, if a LEC acquires a product from a nonregulated affiliate, it codes the cost to the function that will make use of the product. The LEC does not, and should not, code the pension and benefit costs incurred by the nonregulated affiliate to the carrier's pension and benefit account. The additional apportionments suggested in the Notice are unnecessary, and should be rejected.

E. The Commission Should Not Require The Development Of A "Rate Base" By Affiliates Of Carriers Subject To Incentive Regulation.

The Notice states that the Commission staff has developed a generic rate base methodology for nonregulated

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<sup>31</sup> The Notice states that the existing rules require apportionment of nonregulated costs between affiliate transactions and nonaffiliate transactions. BellSouth is aware of no such requirement in the existing rules, and would oppose any such requirement as unduly burdensome.

affiliates to use in determining the fully distributed cost of the services nonregulated affiliates provide to carriers.<sup>32</sup> It seeks comment on whether that generic should be refined and codified.<sup>33</sup> BellSouth opposes both the codification of the existing methodology and the refinements proposed in the Notice.

The regulation of a carrier's "rate base" under cost-of-service regulation was deemed necessary to insure that carriers did not "pad" their costs, since such cost padding, if undetected, would result in higher costs to customers. "Rate base" regulation was necessary because carriers are highly capital intensive, and imprecision in calculating the investment base to which a rate of return is applied could lead to increased costs to customers.

Under incentive regulation, incentives to "pad" investment, either by the carrier or its nonregulated affiliates, no longer exist. Carriers subject to incentive regulation have nothing to gain by paying "padded" prices to affiliates. Such a practice would lower the profits of the carrier, and would not increase carrier charges to its customers. Furthermore, nonregulated affiliates are generally far less capital intensive than carriers. Therefore, even if a carrier were subject to cost-of-service regulation, there would be little to gain from "padding" the

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<sup>32</sup> Notice at ¶ 58.

<sup>33</sup> Notice at ¶ 59.

investment base of nonregulated affiliates. There is absolutely no need for the codification of "rate base" rules for nonregulated affiliates of carriers subject to incentive regulation. The calculation of a nonregulated affiliate's costs in accordance with GAAP accounting provides sufficient assurance of accuracy. The additional costs required to implement a "rate base" requirement for such affiliates is unwarranted.

If the Commission nevertheless adopts a "rate base" methodology for nonregulated affiliates, it should not go beyond the existing generic methodology. That methodology is the result of extensive discussions between the carriers and the Commission staff, and represents a reasonable balance between cost and precision. The addition of rules governing construction costs would simply add administrative costs without any corresponding benefit. Nonregulated affiliates of carriers rarely engage in long term construction projects that are the subject of the carrier rate base rules. The proposal to adopt a rule dealing with "customer deposits" shows just how far afield the quest for theoretical accuracy has taken the authors of the Notice. BellSouth is unaware of any nonregulated affiliate that requires customer deposits. The Commission's legitimate concerns with the reliability of affiliate cost calculations is satisfied by the GAAP requirement. Additional requirements simply serve to increase the administrative

costs associated with affiliate transactions, with no corresponding public benefit.

F. The Commission Should Utilize The Carrier's Earned Interstate Rate Of Return For Affiliate Transactions.

In the Notice, the Commission recognizes that price cap carriers are no longer subject to a rate of return prescription. It requests comment on whether the rate of return used to calculate affiliate transaction costs should reflect the earned interstate rate of return each price cap LEC, after sharing.<sup>34</sup> If the Commission requires a "true-up" of affiliate transaction costs based on actual results, as proposed in the Notice, then the Commission should use the carrier's earned interstate rate of return in the true-up. If the Commission does not include a true-up requirement, the rate of return used in affiliate transactions should reflect the interstate rate of return earned by the carrier in the prior year.

G. The Commission Should Not Require Nonregulated Affiliates' Expenses To Be Calculated In Any Manner Inconsistent With GAAP.

The Notice proposes a series of special rules applicable to the calculation of carrier net income to determine the amount of nonregulated affiliate costs booked in association with affiliate transactions.<sup>35</sup> BellSouth opposes any requirement that the nonregulated affiliates

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<sup>34</sup> Notice at ¶ 69.

<sup>35</sup> Notice at ¶¶ 72-76.

deviate from GAAP accounting in association with affiliate transactions.

Many of the rules sought to be imposed deal with gains and losses on the disposition of assets. The Commission had adopted such rules for the regulated carriers to comply with the standards set forth in the Democratic Central Committee case.<sup>36</sup> None of the assets of a nonregulated affiliate were ever included in the regulated carrier's rate base, nor were their acquisition funded by ratepayers. Therefore, under the applicable legal standard, the Commission cannot include gains or losses on the disposition of such assets in determining the carrier's cost-of-service.

For carriers subject to incentive regulation, the detailed and costly adjustment of expenses proposed in the Notice will result in no benefit and significant cost to customers, since the additional cost to implement and audit the Commission's requirements will be an exogenous adjustment for price cap carriers. The Commission should not adopt the requirements proposed at paragraphs 72-76 of the Notice.

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<sup>36</sup>Democratic Central Committee v. Washington Metropolitan Area Transit Comm'n., 485 F.2d 786 (D.C. Cir. 1973), cert. den., 415 U.S. 935 (1974) ("Democratic Central Committee").

H. The Commission Should Not Require Carriers To Book Estimates. If True-Ups Are Required, They Should Be Performed Annually After Actual Results For The Year Are Available.

The Notice proposes to require that carriers estimate affiliate transaction costs, true-up those estimates quarterly, and make a final true-up prior to the close of the carrier's books for the year. The Notice also proposes to require the use of a one-year period to measure carrier compliance with the affiliate transaction rules.<sup>37</sup>

It is unclear to BellSouth whether the language in the Notice is intended to suggest a requirement that carriers book estimates, rather than actual transactions. If so, BellSouth objects to the proposal, which would constitute a major departure from proper accounting.<sup>38</sup> BellSouth also objects to a requirement that true-ups be made quarterly. An annual true-up is sufficient to ensure compliance with the Commission's rules, and to make any adjustments required to achieve the allowed rate of return. If such true-ups are made by the end of the first quarter, any effect of these adjustments can be reflected in the carrier's annual access tariff filing. The Commission should also clarify that carrier compliance with such a true-up requirement constitutes compliance with the affiliate transaction rules.

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<sup>37</sup> Notice at ¶¶ 77-80.

<sup>38</sup> If the Notice used the term "estimate" to simply indicate that the actual transactions would be subject to a later true-up, then BellSouth does not object to the use of the term.



I. The Proposed Rules Will Greatly Increase The Cost And Complexity Of Independent Audits.

The Notice proposes to expand the scope of the annual independent audit to include compliance with any requirements adopted as a result of this proceeding. As BellSouth has demonstrated above, the proposals contained in the Notice are not necessary to protect ratepayers and would be extremely expensive to implement. Furthermore, the Notice, which is extremely detailed on the measurement of costs, contains virtually no guidance on the methods and procedures to be used to estimate fair market value.<sup>39</sup> The requirement to estimate fair market value for service transactions would require the development of methodologies to perform such analyses that are sure to engender controversy. Therefore, it is reasonable to expect that the cost and complexity of the annual independent audit will grow considerably.

Since the Joint Cost rules became effective, the cost of the annual independent audit has grown substantially due to interpretation of the rules and the addition of new audit requirements by the Common Carrier Bureau. For BellSouth, the basic fee for the annual independent audit has increased 347 percent from 1988 to 1993. The adoption of the proposals contained in the Notice would no doubt result in another substantial increase in the cost of the annual

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<sup>39</sup> Notice at ¶¶ 90-92.

independent audit. The internal resources required to support the audit effort have likewise increased substantially. These increased costs result in no increased output. They represent negative productivity imposed upon the industry by the Commission and its staff. The Commission should give careful consideration to the cost of proposed regulations, and impose such costs only where clearly needed to fulfill the Commission's statutory mandate.

V. Conclusion

The proposals in the Notice represent a classic case of unnecessary and inefficient regulation that will impose substantial costs and no benefits to the public. Instead of adopting the onerous regulations proposed in the Notice, the Commission should eliminate or simplify the existing affiliate transaction rules for carriers subject to incentive regulation, as proposed herein.

Respectfully submitted,

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